UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

May 4, 1998

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515-6115

Dear Representative Dingell:

Thank you for your letter of April 30. I want to commend you for the leadership role that you have taken to protect investors in the course of the financial reform debate. You have worked tirelessly for important provisions like functional regulation in order to afford the nation's growing population of investors the best possible protection.

As discussed with your counsel, attached is a memorandum answering the points in your letter relevant to the mission of the Commission -- protecting investors and protecting the integrity of our capital markets.

Sincerely,

Arthur Levitt

Enclosure

MEMORANDUM

May 4, 1998

TO: Chairman Levitt

FROM: Division of Market Regulation
Office of General Counsel

RE: Proposed Amendments by Reps. LaFalce and Vento to the H.R. 10 Substitute

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This memorandum responds to the points that are relevant to the mission of the Commission raised in a letter from Representative Dingell to you and Chairman Greenspan dated April 30, 1998.

1. Background

The Commission has two primary missions -- investor protection and protecting the integrity of our capital markets. Our markets are the best in the world because securities firms are innovative and take risks. Commission oversight of securities firms is structured accordingly. It is based in large part on requiring compliance with clear rules, while monitoring the financial soundness of the entire entity through risk assessment principles.

By contrast, banking regulation is designed to fulfill a very different mission -- to protect the safety and soundness of the bank, not the individual customer or the market in general. Banking regulators thus take a different, more intrusive, approach in supervising their regulated entities. They supervise the entire organization, with a view toward protecting the insured bank.

Under current law, affiliates of banks are subject to consolidated holding company supervision by the Federal Reserve Board under the Bank Holding Company Act. That means that, as the Glass-Steagall Act is repealed and banks increasingly affiliate with securities firms, those securities firms will become subject to consolidated bank-style supervision and control. Having a securities firm operate under pervasive bank-style regulation may stifle the entrepreneurship that makes our securities markets so vibrant. Securities firms need to be innovative -- to take risks. As a result of this innovation, more capital is raised in our markets than anywhere else in the world, without the benefit of a federal safety net. In testifying on financial reform, the Commission has stressed that securities-bank affiliations need to take place

without subjecting the affiliated securities firm to bank-style safety and soundness regulation.[1]

Under the H.R. 10 substitute agreed between the Commerce and Banking Committees, the Glass-Steagall Act would be repealed and securities-bank affiliations would occur under the bank holding company structure. However, the H.R. 10 substitute addressed the problem of imposing consolidated bank-style supervision on securities firms by providing a less pervasive form of supervision by the bank regulator -- the Federal Reserve Board -- through a group of provisions commonly referred to as "Fed Lite." Among other things, these provisions (i) limit redundant oversight by the Federal Reserve Board viz. bank-affiliated securities firms in significant ways, (ii) require the Board to share information with the Commission with respect to affiliated bank and securities firms, and (iii) provide for Board deference to the Commission with respect to federal securities law issues.

2. The Proposed LaFalce-Vento Amendments

The proposal offered by Congressmen LaFalce and Vento in their amendments dated April 29, 1998 would allow securities underwriting and other securities activities to occur through a bank operating subsidiary model. Under this approach, an operating subsidiary (op sub) of a national bank, subject to comprehensive oversight by the Office of the Comptroller of the Currency ("OCC') under the National Bank Act, could engage in activities that are considered "financial." The OCC would have flexible authority to interpret the term "financial." Notably, under the National Bank Act, the OCC exercises similar comprehensive authority over bank subsidiaries -- aimed at bank safety and soundness -- as the Federal Reserve Board does under the Bank Holding Company Act. However, the op sub structure proposed in the LaFalce-Vento amendments does not include an alternative for reduced bank-style oversight similar to the "Fed Lite" alternative provided in the H.R. 10 substitute. The Commission believes that "the same concerns regarding consolidated supervision arise regardless of whether a bank affiliates with a broker-dealer under a holding company or through an operating subsidiary structure."[2]

Discussed below are some of the provisions in the H.R. 10 substitute that are not replicated in the LaFalce-Vento amendment.

a. Use of Commission Reports and Exams. The regulatory scheme proposed for op subs in the LaFalce-Vento amendments would not require the OCC to use existing reports of the Commission or to limit its examinations of non-bank entities when overseeing a securities op sub, in the same way that the Federal Reserve would be limited for securities affiliates under the H.R. 10 substitute. The cooperation between the regulators envisioned by the H.R. 10

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[1] Testimony of Arthur Levitt before the House Committee on Banking and Financial Services, May 22, 1997, p. 17.

[2] Id. at n. 20.

substitute is vital, given their different missions and perspectives (as described above).

b. Consultation with Commission. Similarly, the OCC would not be required to consult with the Commission when taking adverse action (such as ordering divestiture or cessation of activities) against a securities op sub. A securities subsidiary could be highly capitalized and very successful. But if it is affiliated with an unsuccessful bank, the bank regulator could order it sold in a "fire sale" to prop up the capital position of the bank. The Federal Reserve would be required under the H.R. 10 substitute to consult with the Commission before requiring divesture of a broker-dealer affiliate of a bank, permitting the Commission to voice such concerns. However, the OCC in the LaFalce amendment has complete authority to require divestiture of a broker-dealer subsidiary without any consultation requirement. This consultation is important because the banking regulators and the Commission have such different mandates for their regulated entities.

c. Back-up Examination Authority. The amendments to H.R. 10 offered by Representative Dingell would provide the Commission with back-up examination authority over wholesale financial holding companies. With this authority, the Commission has the ability to examine a questionable transaction from start to finish so that it can monitor and enforce compliance with the federal securities laws. The proposed op sub amendments have no comparable authority for the Commission.

d. Commercial Activities. The H.R. 10 substitute also limits nonbanking (or commercial) activities that financial holding companies may conduct. These limits would not apply to op subs under the proposal offered by Congressmen LaFalce and Vento. Thus, any changes to the existing nonbanking prohibitions would not affect the activities of op subs. Because the OCC could allow an op sub to conduct any activity that it deems "financial," the possibility exists that a traditionally "commercial" activity could be approved and later grow to dwarf the size of the parent national bank, regardless of any limit on commercial activities applied to financial holding companies.

3. General Observations

Regardless of the type of structure used, the Commission has testified that it believes that banks actively engaged in public securities business must do so within a separate entity that complies fully with the securities laws.[3] This will allow the Commission to continue to fulfill its mission of protecting investors and protecting the integrity of the markets.

The Commission has testified that it prefers the affiliate structure to the bank operating

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[3] See generally, Testimony of Arthur Levitt before the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce, July 17, 1997.

subsidiary structure.[4] The affiliate structure offers a greater separation and creates sharper distinctions between the bank and any related securities firm. A clear separation between banking and securities functions guards against confusion.

[4] Testimony of Arthur Levitt before the House Committee on Banking and Financial Services, March 15, 1995, p. 13.